

SURREBUTTAL TESTIMONY OF

MATTHEW P. SCHELLINGER II

ON BEHALF OF

THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF

DOCKET NO. 2018-358-WS

**IN RE: VERIFIED APPLICATION OF CAROLINA WATER SERVICE,
INCORPORATED FOR APPROVAL OF ANNUAL RATE ADJUSTMENT
MECHANISMS AND PETITION FOR AN ACCOUNTING ORDER TO DEFER
EXPENSES**

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND OCCUPATION.

A. My name is Matthew P. Schellinger II. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina, 29201. I am employed by the Office of Regulatory Staff (“ORS”) in the Utility Rates and Services Division as a Regulatory Analyst.

Q. DID YOU FILE DIRECT TESTIMONY AND EXHIBITS IN THIS PROCEEDING?

A. Yes. I filed direct testimony and two (2) exhibits with the Public Service Commission of South Carolina (“Commission”) on May 30, 2019.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS PROCEEDING?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Blue Granite Water Company (“BGWC” or the “Company”) witness Robert Hunter.

Q. PLEASE PROVIDE AN OVERVIEW OF THE FILINGS IN THIS DOCKET.

1 **A.** The Company filed its original Application on November 14, 2018 and requested
2 the proposal contained in the Application be put into effect without notice or hearing. The
3 Company's original Application requested approval of an annual rate adjustment ("ARA")
4 mechanism and for authority to continue to defer water and wastewater expense increases.
5 On November 21, 2018, ORS requested the Company provide notice to its customers and
6 for the Commission to establish a hearing on this matter. On December 3, 2018, the
7 Company responded via letter to ORS's request for customer notice and a hearing, and
8 notified the Commission of the Company's intent to amend the Application to request
9 Commission approval of a rate increase, should the Commission rule that customer notice
10 and a hearing is required. On December 5, 2018, via Order No. 2018-790, the Commission
11 denied BGWC's request for a waiver of notice and hearing, and suspended the provision
12 of a draft notice pending the Company's amended Application.

13 The Company filed an amended Application on February 21, 2019 - nearly three
14 (3) months after notifying the Commission of the intention to file such an amended
15 Application. The amended Application requested an increase in customer rates effective
16 upon Commission Order. The Commission required a notice be sent to customers and, after
17 several revisions, the Notice of Filing was issued on March 28, 2019. The Company
18 provided proof of publication of the Notice of Filing on May 2, 2019.

19 **Q. DID THE COMPANY REQUEST A CHANGE TO THE RATE DESIGN WHICH**
20 **WAS APPROVED IN COMMISSION ORDER NO. 2018-345(A)?**

21 **A.** Yes. The Company seeks more timely recovery of the cost of purchased water and
22 wastewater treatment charges from third-party providers.¹ The Company's request to

¹ Amended Verified Application, page 6.

1 establish an ARA mechanism is a change to the Commission-approved rate design. Further,
2 in the Amended Verified Application filed by the Company, page 6, the Company states
3 that "... in lieu of continued deferral of such expenses, the Applicant is seeking timely cost
4 recovery of its purchased water and wastewater treatment expenses through annual periodic
5 rate adjustment mechanisms, along with authorization to defer such expenses caused by
6 changes in third party provider rates on an interim basis (above or below the amounts
7 reflected in base rates), until such expenses are reflected in rates." The Company's request
8 for an ARA mechanism is not in lieu of continued deferral of such expenses because the
9 Company requests to change rates and Commission authorization to continue to defer such
10 expenses.

11 **Q. DOES ORS RECOMMEND A CHANGE TO THE COMPANY'S APPROVED**
12 **RATE DESIGN?**

13 **A.** No. As stated in my direct testimony, ORS does not recommend the Commission
14 approve the ARA mechanism or any change to customer rates.² The current rate design
15 permits the Company to recover costs of purchased water and wastewater treatment
16 charges from third-party providers and authorizes the Company to defer changes in third-
17 party provider rates for future recovery. The current rate design provides customer
18 protection and an opportunity for a thorough review in the next general rate proceeding. A
19 drawback for customers resulting from the Commission-approved rate design is potential
20 rate volatility due to the large deferral balance. BGWC experienced several significant
21 increases in rates from the City of West Columbia and York County which caused the
22 deferral account balance to grow quickly. In the next general rate proceeding, the

² Schellinger Direct Testimony, page 11, lines 10-12.

amortization period for the deferral account balance will be determined and consideration must be given to balance timely cost recovery for the Company and minimize rate volatility for customers.

Q. DO YOU AGREE WITH COMPANY WITNESS HUNTER'S STATEMENT THAT UTILITIES MERELY SERVE AS A CONDUIT FOR THESE THIRD-PARTY CHARGES?³

A. No. The water distribution and wastewater collection functions of BGWC are much more than a "conduit for these third-party charges." Operational efficiency requires the Company to maintain, replace and monitor distribution and collection lines and other critical infrastructure to support system reliability and low-cost operations. Witness Hunter's testimony seems to abdicate the Company's responsibility for efficient operations. Commission Regulations 103-540 and 103-740 require the Company to "...operate and maintain in safe, efficient and proper conditions all of its facilities and equipment..." An efficient and effective utility will control non-revenue water and inflow and infiltration to minimize the impacts on its customers. Witness Hunter's claim that non-revenue water items are a "...reasonable cost of doing business" reinforces ORS's concerns that BGWC customers would be obligated to pay for uncontrolled non-revenue water and inflow and infiltration if the Company's ARA mechanism is approved as proposed. ORS's next opportunity to review non-revenue water and inflow and infiltration will be in its analysis of the deferral account balance in the next general rate proceeding.

Q. DO YOU AGREE WITH WITNESS HUNTER'S CHARACTERIZATION OF YOUR TESTIMONY?

³ Hunter Rebuttal Testimony, page 12, lines 10-11.

1 A. No. Witness Hunter states that “All parties appear to agree that, conceptually, a rate
2 adjustment mechanism to pass through third-party provider water and wastewater expenses
3 is reasonable...”⁴ This statement is inconsistent with my Direct Testimony on page 11.
4 ORS recommends the Commission reject the Company’s ARA mechanism and request to
5 increase rates. In my Direct Testimony, I outline a path forward for BGWC that may allow
6 for a pass-through mechanism to pass through the change in rates from the third-party
7 providers. ORS recommends any adjustment to rate design be accomplished in the next
8 general rate proceeding.

9 **Q. HOW IS THE PASS-THROUGH OF A CHANGE IN RATES DIFFERENT THAN**
10 **A PASS-THROUGH IN THE CHANGE OF EXPENSES AS PROPOSED BY**
11 **BGWC?**

12 A. It is important to note that the pass through of a change in rates is fundamentally
13 different than the pass through of a change in expenses. The Company’s Application
14 (original and amended) requests an ARA mechanism to recover purchased water and
15 wastewater treatment expenses resulting from the corresponding change in rates from the
16 third-party provider. The Company’s Application indicates on page 8 the purpose of the
17 ARA mechanism is to ensure the Company is “... recovering its actual purchased water
18 and wastewater treatment expenses on a timely basis...” The Company’s proposed ARA
19 mechanism bases the calculation of the annual rate change to customers on the level of
20 expenses incurred by the Company which includes non-revenue water, changes in
21 customer consumption and inflow and infiltration. As stated by Witness Hunter, the
22 Company’s calculation of the ARA mechanism requests recovery from customers for the

⁴ Hunter Rebuttal Testimony, page 2, lines 17-18.

1 cumulative purchased water and wastewater treatment expenses from third-party
2 providers.⁵

3 The Company's proposal is very different than the Purchased Water Adjustment
4 approved for Kiawah Island Utility, Inc. ("KIU"). See Schellinger Direct Exhibit MPS-1
5 page 5 and 6. The Purchased Water Adjustment and Purchased Sewer Adjustment
6 Mechanisms offered by ORS in Schellinger Direct Exhibit MPS-2 protect customers from
7 non-revenue water, changes in customer consumption and inflow and infiltration. ORS
8 recommends any pass-through mechanism approved by the Commission be based on the
9 rate change of the third-party provider. ORS's recommendation is transparent to
10 customers as customer's can directly relate a rate change from a third-party provider to a
11 rate change for BGWC.

12 **Q. PLEASE PROVIDE A COMPARISON BETWEEN KIU'S PURCHASED WATER**
13 **ADJUSTMENT AND BGWC'S PROPOSED ARA.**

14 **A.** I offer the following example for illustrative purposes:

15 If KIU receives an \$0.11 per 1,000 gallons increase from its third-party provider, St. John's
16 Water Company, KIU bills the customer an additional \$0.11 for each 1,000 gallons
17 consumed by the customer. This is in accordance with the tariff approved by the
18 Commission in Order No. 2019-288. Likewise, if KIU receives a bill from St. John's Water
19 Company for 1,000,000 gallons, but can only bill customers for 900,000 gallons based on
20 KIU's customer meter readings, KIU is limited to charging its customers only for the rate
21 change of \$0.11 per 1,000 gallons. KIU is not allowed to charge its customers the \$11 cost
22 associated with the 100,000 gallons of non-revenue water. This mechanism is a change in

⁵ Hunter Rebuttal Testimony, page 10, line 15.

1 third-party provider rates that is being passed on and paid for by customers without markup
2 or margin.

3 Unlike KIU's approved Purchased Water Adjustment, BGWC's proposal would
4 allow the Company to accumulate a change in third-party provider expenses based on a
5 historical amount billed from the third-party provider, with no relation to the customer's
6 consumption at that time. The Company would then be authorized to recover the entirety
7 of the change in expense over the following twelve (12) month period based on the average
8 customer consumption during that historical period. The Company's ARA mechanism
9 requires the customers of BGWC to bear the burden of non-revenue water. If the Company
10 is billed by the third-party provider for an additional \$10,000 due to the change in expenses,
11 the Company will increase rates to customers to fully recover the accumulated expense of
12 \$10,000 which may include non-revenue water. The Company's proposed ARA
13 mechanism will require customers to pay for all changes in accumulated expenses.
14 Contrary to Witness Hunter Rebuttal Testimony, the mechanisms are different, and the
15 Company is not "simply seeking recovery for the pass-through rate adjustments in the same
16 manner."⁶

17 **Q. WHY IS A TRUE-UP MECHANISM NECESSARY?**

18 **A.** If the Company passes through only changes in rates charged by third-party
19 providers and recovers the deferral in the context of a general rate case, then a true-up
20 mechanism is not necessary. When the Company receives an increase from a third-party
21 provider, the Company will pass on that same rate increment directly to a customer using
22 that customer's actual consumption which eliminates the opportunity for any over or under

⁶ Hunter Rebuttal Testimony, page 12, lines 1-16.

1 collection. The fact that a true-up is necessary under the Company's proposed ARA
2 mechanism illustrates that the Company's proposal is not similar to other pass-through
3 mechanisms approved by the Commission.

4 Should the Company's mechanism be approved as proposed, a true-up mechanism
5 is necessary to ensure the Company only recovers the actual deferred expenses and expense
6 increases which is caused by use of historical customer consumption data.

7 **Q. WHY IS THE HISTORY OF THE COMPANY'S RATE DESIGN RELEVANT IN**
8 **THIS PROCEEDING?**

9 **A.** The consolidated rate design that the ORS and the Company worked collaboratively
10 on in the Company's 2015 general rate case (Docket No. 2015-199-WS) was developed to
11 remove a confusing and complex pass-through rate adjustment mechanism, to allow cost
12 recovery of purchased water and wastewater treatment costs from third-party providers as
13 an O&M expense, and to establish a deferral account that would "reduce customer
14 confusion and provide consistent and transparent rates."⁷ ORS did not dispute the use of
15 the rate design with continued deferral accounting treatment in the 2017 rate case (Docket
16 No. 2017-292-WS).

17 The Company's proposal to establish an ARA mechanism in this proceeding is a
18 change to the current rate design approved by the Commission. BGWC and ORS met on
19 several occasions and continued to share ideas on solutions to manage the building deferred
20 account balance, reduce rate volatility for customers and ensure timely recovery of
21 purchased water and wastewater treatment expenses. It continues to be ORS's position

⁷ Willie Morgan Direct Testimony, Docket No. 2015-199-WS, page 8.

1 that the proper implementation of pass-through mechanism would best be handled in the
2 context of the Company's next general rate proceeding.

3 **Q. DOES ORS SUPPORT A RETURN TO THE COMPANY'S PREVIOUS RATE**
4 **DESIGN?**

5 **A.** No. Witness Hunter claims that "It appears that the ORS now supports a return to
6 the Company's previous rate design."⁸ It is the position of ORS that the current rate design
7 and current deferral accounting treatment are appropriate, provide adequate cost recovery
8 treatment for the Company for changes in third-party provider expense increases, and are
9 in the public interest. The Company desires to change the current process in a manner that
10 benefits the Company and disadvantages the customers.

11 Witness Hunter states that "The ORS is entitled to change its policy preferences,
12 but the Company should not be penalized for designing a rate adjustment mechanism that
13 is compatible with the rate design that the ORS previously favored."⁹ It is evident that the
14 Company, not ORS, changed its position regarding the recovery of third-party provider
15 increases. The approved deferred accounting treatment benefits the Company by
16 authorizing the Company to receive full recovery of the prudently incurred third-party
17 provider increases. BGWC is currently recovering \$223,269 in deferral expenses attributed
18 to third-party provider purchased water and wastewater expenses annually based on the
19 Commission Order No. 2018-345(A).

20 **Q. DOES BGWC'S PROPOSED ARA MECHANISM RESULT IN RATES THAT**
21 **SEND ACCURATE PRICE SIGNALS?**

⁸ Hunter Rebuttal Testimony, page 6, lines 15-16.

⁹ Hunter Rebuttal Testimony, page 6, lines 16-19.

1 A. No. Upon the consolidation of the Company's rates into a single-tariff, a significant
2 shift occurred between the Company's cost to serve a customer for the next gallon of water
3 and the prices that the Company is charged for that water. The rate consolidation
4 undertaken by BGWC has completely separated the customer's costs from the Company's
5 costs. This aggregation of rates results in minimal cross subsidization which is largely
6 offset by the numerous benefits that single-tariff pricing provides to the Company and its
7 customers. Therefore, Witness Hunter's statement that a pass-through mechanism is
8 necessary for adequate price signals¹⁰ has no merit. The United States Environmental
9 Protection Agency ("EPA") and National Association of Regulated Utility Commissioners
10 ("NARUC") Report titled Consolidated Water Rates: Issues and Practices in Single-Tariff
11 Pricing, addresses the key advantages and disadvantages of single-tariff pricing. While
12 there is no perfect solution to single-tariff pricing, one disadvantage is that "... single-tariff
13 pricing also seems to be at odds with water conservation, in that it appears to weaken price
14 signals and thus undermine efficient production and consumption."¹¹

15 Q. PLEASE EXPLAIN THE DIFFERENCE BETWEEN THE TWO CLASSES OF
16 SEWER CUSTOMERS IN THE COMPANY'S TARIFF.

17 A. As shown in revised application Exhibit G, page 9, the Company's tariff identifies
18 two (2) different classes of customers that receive sewer service from BGWC. The first
19 customer class receives Sewer Collection & Treatment Only – meaning that BGWC uses
20 Company collection and treatment assets to provide service to the customer. The second
21 customer class receives Sewer Collection Only – meaning BGWC uses Company-owned

¹⁰ Hunter Rebuttal Testimony, page 9, lines 2-3.

¹¹ U.S. Environmental Protection Agency. (1999). *Consolidated Water Rates: Issues and Practices in Single-Tariff Pricing*. p. 4. Retrieved from <https://nepis.epa.gov>

collection system infrastructure and purchases sewer treatment services from a third-party provider to provide service to the customer. The rates for service are the same under Commission Order No. 2018-345(A). However, these customers classes are distinct. It is not equitable or reasonable to design an ARA mechanism to require Sewer Collection & Treatment customers to absorb increases from third-party wastewater treatment providers when the customer receives no service from the third-party wastewater provider.

Q. PLEASE EXPLAIN WHY RECOVERY OF A DEFERRAL BALANCE SHOULD BE DETERMINED DURING THE COMPANY'S NEXT GENERAL RATE PROCEEDING.

A. ORS is not aware of an instance where the Commission has authorized recovery of a deferred account balance outside of a general rate proceeding. Most recently, the Commission determined the proper treatment of deferral account balances for Duke Energy Carolina, LLC and Duke Energy Progress, LLC (Docket Nos. 2018-319-E and 2018-318-E, respectively) within a general rate proceeding. The Financial Accounting Standards Board (FASB) in ASC 980 provides, among other things, general standards of accounting for the effects of regulation and provides that according to ASC 980-340-25-1:

Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

- a. It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
- b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion

1 requires that the regulator's intent clearly be to permit recovery of the
2 previously incurred cost.¹²

3 As has typically occurred in the past, once an accounting order is issued by the
4 Commission to establish the deferral account, the Company will request recovery of the
5 regulatory assets in a future general rate case proceeding. It is during the general rate case
6 proceeding, the Commission may determine the appropriate amount of allowable costs to
7 be recovered from customers, and the manner in which the Company is allowed to recover
8 previously deferred costs.

9 Recovery of the deferral account balance outside of a general rate proceeding may
10 result in single-issue rate making in which the Company benefits from a revenue
11 requirement higher than otherwise would be required if all expenses and revenues to
12 determine the revenue requirement are considered by the Commission. A utility should net
13 all costs and benefits of operations when rates are set to avoid "cherry-picking" expense
14 increases that may be offset by other cost decreases. Customers may be disadvantaged by
15 the Company's request to depart from the traditional rate-setting processes. Besides
16 increased costs to customers, it can shift the risks away from the Company shareholders
17 and onto BGWC customers.

18 **Q. IS WITNESS HUNTER'S REBUTTAL EXHIBIT RELEVANT TO THIS**
19 **PROCEEDING?**

20 **A.** No. The inclusion of prospective rate increases from third-party providers is not
21 relevant to this proceeding. The Company currently has a deferral account established that
22 adequately protects the Company from increases in third-party provider costs while

¹² FASB (Financial Accounting Standards Board). (n.d.) ASC 980-340-25-1. Retrieved *June 7, 2019*, from FASB Accounting Standards Codification database.

1 providing both the ORS and the Commission the opportunity to review the changes in
2 costs. The inclusion of this exhibit does not show that there is some greater need to establish
3 an alternative rate recovery mechanism. Furthermore, the witness for York County, Mr.
4 David Hughes, supports ORS's position that any pass-through mechanism should be
5 transparent and directly attribute the water and sewer rate increases to the customers that
6 receive service from the third-party provider that increases (or decreases) the rates.

7 **Q. IS THE NON-REVENUE WATER AMOUNT ANALYZED IN THE COMPANY'S**
8 **LAST GENERAL RATE PROCEEDING IMPORTANT?**

9 **A.** No. Witness Hunter states, "the non-revenue water adjustment in its most recent
10 rate case was equal to 0.55 percent of the purchased water expense approved."¹³ The usage
11 of this percentage as a BGWC system-wide non-revenue water percentage is misleading
12 and irrelevant. In the Company's last general rate proceeding (Docket No. 2017-292-WS),
13 all purchased water expenses incurred from York County were based on the meter readings
14 taken by BGWC for customers in that service territory. Subsequently, the agreement with
15 York County was revised and BGWC is now billed for purchased water based on master
16 meter readings taken by York County. The Commission approved, in Order No. 2018-325,
17 a new BGWC franchise agreement with York County, therefore, the non-revenue water
18 calculations reflecting the revised terms of the new franchise agreement should be
19 reviewed during the next general rate case. Best practices in the water and wastewater
20 industry indicate non-revenue water and inflow and infiltration should be analyzed on a
21 per system basis and not on a system wide basis.¹⁴ Individual water systems could have

¹³ Hunter Rebuttal Testimony, page 13, lines 2-4.

¹⁴ American Water Works Association. (2009). *Water Audits and Loss Control Programs* (Manual of Water Supply Practices M36). Denver, CO: American Water Works Association.

1 non-revenue water in excess of 30% while not contributing significantly to the system-
2 wide water loss statistics.

3 There were significant errors in the Company's meter reads during the 2017 general
4 rate case that caused substantial issues in accurately determining the Company's non-
5 revenue water. To account for the meter read errors, ORS recommended an adjustment to
6 increase consumption amounts, rather than as an adjustment for non-revenue water.¹⁵
7 Witness Hunter's calculation of non-revenue water does not reflect the ORS adjustment to
8 impute customer consumption to correct the meter reading errors during the Company's
9 test year.

10 **Q. DOES THE INCLUSION OF ALTERNATIVE RATE RECOVERY**
11 **MECHANISMS REDUCE THE RISK TO THE COMPANY?**

12 **A.** Yes. ORS Witness Parcell discussed in both Duke Energy Carolinas, LLC and
13 Duke Energy Progress, LLC last general rate cases (Docket Nos. 2018-319-E and 2018-
14 318-E) that favorable regulatory mechanisms that enhance cost recovery reduce the risk to
15 the utility. "Those mechanisms, on both an independent and collective basis, have the effect
16 of transferring a portion of DEC's risk from its shareholders to its ratepayers. This is the
17 case since the risk of fully recovering certain expenses is reduced or eliminated."¹⁶

18 This rate adjustment mechanism proposed by BGWC shifts the risk from
19 shareholders to its ratepayers, but does not include a commensurate reduction in the 10.5
20 percent allowed return on equity.

21 **Q. IS THE PROPOSAL BY BGWC FOR AN ARA MECHANISM A FORM OF**
22 **ALTERNATIVE RATEMAKING?**

¹⁵ Schellinger Direct Testimony, Docket No. 2017-292-WS, page 7, lines 18-19 and page 8, lines 1-8.

¹⁶ Parcell Direct Testimony, Docket No. 2018-319-E, page 21, lines 4-6.

1 **A.** Yes. In the Company's recent allowable ex parte briefing before the Commission,
2 Company representatives identified that regulatory lag impacts the Company's overall
3 financial health and financial performance. To mitigate regulatory lag, the Company
4 indicated it would be focused on the adoption of new ratemaking methodologies including
5 a future test year, banded return on equity or a five-year rate plan and/or an infrastructure
6 surcharges. The Company also identified that legislative change would be needed to
7 implement the new ratemaking methodologies. ORS considers the ARA mechanism, as
8 proposed in the Company's Application, to be a form of alternative ratemaking which
9 would reduce regulatory lag and boost the financial performance of the Company. In the
10 manner proposed in the Application, the Company would immediately receive a boost in
11 revenue through increased rates to customers. The corresponding benefit to customers is
12 not evident or immediate. In the next general rate case, the Commission can balance
13 recovery of the deferral account and an adjustment to the rate design against other expenses
14 and the benefits of the 2017 Tax Cuts and Jobs Act to ensure the customer's rates are set
15 appropriately.

16 **Q. PLEASE PROVIDE ORS'S RECOMMENDATIONS RELATED TO THIS CASE.**

17 **A.** ORS recommends the Commission deny the Company's request to establish an
18 ARA mechanism and deny the Company's request to change rates. ORS recommends the
19 Commission authorize the Company to continue to defer purchased water and wastewater
20 treatment expenses caused by changes in third-party provider rates until such a time as
21 expenses are reflected in rates. The Company has indicated to this Commission that the
22 Company intends to file a general rate case in September 2019.¹⁷ The Company will have

¹⁷ Transcript ND-2019-6-WS, page 64.

an opportunity in the upcoming general rate proceeding to request recovery of the deferral account balance and adjust its rate design.

Q. WILL YOU UPDATE YOUR SURREBUTTAL TESTIMONY BASED ON INFORMATION THAT BECOMES AVAILABLE?

A. Yes. ORS fully reserves the right to revise its recommendations via supplemental testimony should new information not previously provided by the Company, or other sources, become available.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.